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SUBJECT: CROSS-STRAIT ECONOMIC LIBERALIZATION - THE WAY
FORWARD FOR TAIWAN

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[N](#). TAIPEI 4717
[O](#). TAIPEI 4719
[P](#). TAIPEI 4778

Classified By: AIT Director Douglas H. Paal, Reason 1.5 b

Summary

[1](#)1. (C) Over the past two decades, Taiwan has gradually lifted many restrictions on cross-Straits economic relations resulting in the PRC becoming Taiwan's largest trade partner and top investment destination. However, many restrictions remain, and many liberalization proposals continue to languish. AIT assesses that Taiwan should first implement measures that allow people to move more freely across the Strait. Second, Taiwan should allow money to flow, then technology, and finally it should free the movement of goods into Taiwan from the Mainland. These measures will benefit the economies of Taiwan and the PRC and will also contribute to U.S. economic and security interests. Some important measures may be implemented soon including regular passenger and cargo charter flights and opening of tourism. However, the apparent postponement of the Economic Development Advisory Conference (EDAC) following the ruling Democratic Progressive Party's (DPP) sound defeat in the December 3 local elections is a sign that the Chen administration is unlikely to speed the pace of cross-Straits economic liberalization. Continued advice from U.S. officials to both sides of the Strait to take pragmatic steps will be essential to further progress on liberalization measures. End summary.

Lingering Restriction in the Face of Rapid Integration

[1](#)2. (U) Taiwan has gradually lifted many restrictions on economic relations with the PRC over the last two decades. Starting with permission to visit family members in the Mainland in 1987, liberalization of indirect telecommunications and postal services in 1989, and lifting the ban on investment in the PRC in 1990, economic ties with the PRC have grown dramatically. Today the PRC is Taiwan's number one trade partner and the destination for nearly 70 percent of approved outward investment each year (plus more unapproved investment to boot). Every month more than 350,000 Taiwan visitors travel to the Mainland. It is no exaggeration to say that cross-Straits economic relations affect everyone in Taiwan.

[1](#)3. (C) However, progress toward liberalization has come very slowly in recent years under the DPP administration. The Renminbi exchange pilot program in Kinmen and Matsu (ref K), for example, languished with all preliminary steps completed more than a year before final approval to proceed. In a similar vein, we will soon see the third round of Lunar New Year charter flights since 2003 (ref N), which highlights the failure of the two sides to reach an agreement on regular air links. Other reform proposals continue to suffer long delays in the approval process.

Recommendations for Taiwan's Cross-Straits Economic Agenda

[1](#)4. (C) With numerous restrictions remaining across a broad range of sectors, Taiwan has ample possibilities for cross-Straits economic liberalization. Based on discussions with a wide variety of businesses, academics and government officials, both foreign and Taiwan, AIT offers the

following priorities for Taiwan's liberalization agenda based on Taiwan's own economic interests:

First, Let the People Move

-- (C) Establish Direct Air Links - The single most important step Taiwan must take is to establish direct air links with the PRC. Direct air links will facilitate every form of cross-Strait economic interaction. The lack of direct links causes more unnecessary expense and difficulty than any other cross-Strait restriction.

-- (C) Liberalize Entry Permits for PRC Workers - Taiwan needs to make it easier for firms to bring PRC employees to Taiwan for short-term activities and long-term employment. This was one of the highest priorities identified by the American Chamber of Commerce in Taipei in its 2005 White Paper (ref F). This is especially important as firms complain of a shortage of skilled workers in Taiwan's high-tech industries (ref H). Progress has been made in this area but more is needed (ref L). When combined with direct air links, less restrictive entry permit regulations will also have a strong positive effect on Taiwan government efforts to encourage firms to set up their regional operations headquarters in Taiwan. Taiwan entrepreneurs would be able to maintain headquarters and research and development operations in Taiwan even as they expand manufacturing and sales operations in the PRC. Foreign firms could integrate Taiwan into their greater China operations and even maintain their regional headquarters on the island. Without direct air links and more cross-Strait personnel mobility, Taiwan and foreign firms alike will increasingly abandon the island.

-- (C) Open Tourism - More than any other measure, opening Taiwan to PRC tourists traveling direct from the Mainland will have an immediate positive impact on the domestic Taiwan economy. Industry observers are confident that tourists will come and spend significant amounts of money to the benefit of Taiwan's underdeveloped tourist industry (ref E). Many cite the example of Hong Kong and the important role PRC tourism has played in its recent economic success. At about 3 million visitors per year, Taiwan is dwarfed by Hong Kong's more than 14 million and similar numbers elsewhere in the region.

Second, Let the Money Move

-- (C) Remove Investment Caps - Taiwan firms across all industries complain about restrictions on the total amount of capital they are permitted to invest in the PRC. Taiwan has a graduated schedule of limits on investment in the PRC based on a firm's total capital. Most firms are not permitted to invest more than 40 percent of their total capital. The largest firms are limited to even lower percentages. These restrictions are not effective in keeping investment in Taiwan. They are effective in encouraging firms to use less transparent business practices to hide their investment, sometimes illegally, or to abandon Taiwan entirely (ref M). They have also proved effective in keeping American firms from using Taiwan to operate in China.

-- (C) Permit Renminbi Exchange - The ability to exchange Renminbi in Taiwan will be essential to realize the full potential of increased tourism from the PRC, once that is opened. In addition, current restrictions unnecessarily inconvenience business travelers. Although looser restrictions on Taiwan's offshore banking units facilitate business transactions, the current regulations still impose a needless burden without achieving any economic or security benefits for Taiwan.

-- (C) Liberalize Banking Investment - The Taiwan government has embarked on an ambitious financial reform plan, whose aims include making Taiwan a regional financial center. However, Taiwan banks are not permitted to provide banking services in the PRC, their most logical market for expansion. Nearly 70 percent of Taiwan's approved outward investment goes to the PRC. By prohibiting Taiwan banks from opening branches in the Mainland, the government excessively restrains Taiwan banks in the one foreign market where they might have a competitive advantage. Given that a key determinant of bank competitiveness is scale, restrictions add to Taiwan's challenges.

Third, Let the Technology Move

-- (C) Liberalize Semiconductor Investment - Even as some IT industries farther down the supply chain, such as laptop PC manufacturing, have moved almost all of their production to the PRC (ref O), Taiwan still prohibits certain forms of investment in high-tech industries, especially

semiconductor manufacturing. These regulations are ostensibly aimed at keeping sensitive technology out of the PRC and preserving Taiwan's manufacturing base in these industries. However, many of the technologies that are restricted are already in use in the PRC by local as well as foreign companies (refs D and G). Moreover, the restrictions prevent Taiwan's most successful firms from competing in the industry's fastest growing market; soon to be the world's largest consumer of semiconductors. Taiwan should quickly remove investment restrictions on semiconductor packaging and testing and semiconductor manufacturing with feature size no finer than 0.18 microns (currently manufacturing investment is only permitted at the 0.25-micron level and above). It should also consider further liberalization of semiconductor manufacturing and semiconductor design. U.S. firms are already exporting these technologies to the PRC either through direct investment or equipment sales to PRC firms. If Taiwan firms are not allowed to compete, PRC competitors will have the market protection that could allow them to dominate the industry's key market, costing Taiwan its currently considerable competitive edge.

-- (C) Liberalize TFT-LCD panel manufacturing - The TFT-LCD industry faces a similar situation to semiconductors. Taiwan firms are among the world's most important players, but they are unable to build TFT-LCD panel manufacturing facilities in the PRC where most of the panels are assembled into consumer goods (ref B). The current restrictions hold back what are arguably Taiwan's two most competitive and economically important industries.

Fourth, Let the Goods Move

-- (C) Establish Direct Maritime Links - Although shipping companies have found ways to comply with the letter of Taiwan regulations that prohibit direct shipping with only minimal increases in shipping costs, current restrictions still impose unnecessary burdens on shipping firms and their customers (ref A). The regulations also reduce the attractiveness of Taiwan ports. With the rapid growth of PRC ports, Kaohsiung's harbor has fallen from the world's third busiest container port to the sixth and stands to fall further. In addition, Taiwan's free trade port initiative aimed at attracting more investment to Taiwan's harbors has had difficulty in attracting tenants to the new zones. The lack of direct links is an important obstacle to Taiwan's goal of becoming a regional logistics center. Taiwan's major geographic advantage is its proximity to the Chinese market. Without direct links, that advantage is left languishing on the shelf.

-- (C) Lift Import Prohibitions - Taiwan still maintains import prohibitions on numerous goods produced in the PRC. Many of the prohibitions violate WTO commitments. The removal of prohibitions on automobiles and auto parts as well as certain food items, especially chocolate, has been a high priority for some U.S. & foreign firms. They argue that these prohibitions prevent foreign firms from integrating Taiwan into their regional operations. If forced to choose between the two markets or establish manufacturing facilities in both, many foreign firms are likely to choose to leave or bypass the Taiwan market. However, the U.S. must also be mindful of the impact of the removal of such restrictions. In addition to local producers who could be negatively affected, removal of some restrictions, especially on certain agricultural products, will have a strong negative impact on U.S. exports to Taiwan.

And Don't Forget Other Industries

-- (C) Liberalize Telecommunications Investment - Taiwan telecommunications firms have entered into numerous cooperative arrangements with Mainland firms to try to capitalize on the growing demand for cross-strait services (ref C). However, they are still prohibited by Taiwan from most forms of investment in the Mainland. These regulations are counterproductive to Taiwan's goals for developing digital-content industries.

-- (C) Allow Naptha Cracker Investment - Taiwan's petrochemical firms, especially Formosa Plastics Group (FPG), are eager to build naptha cracker facilities in the PRC that would allow them to expand their downstream petrochemicals production and further exploit their most important market (ref I).

Benefits to U.S. Interests

15. (C) All of these liberalization proposals will potentially benefit the economies of both Taiwan and the PRC. They are also strongly in U.S. economic and security

interests. Many of these measures would have a direct impact on U.S. businesses in the region, most importantly by allowing them to better integrate Taiwan operations into their broader strategy for greater China. In addition, many U.S. exporters and U.S. investors in the region will benefit from stronger growth in Taiwan.

16. (C) More importantly, closer economic ties between Taiwan and the Mainland will help reduce tensions and encourage both sides to move forward on negotiating solution to the issue of Taiwan's status, eliminating one of the most dangerous threats to regional stability. In addition, stronger economic links could enhance Taiwan's influence on Mainland society, increasing exposure to Taiwan's stronger rule of law and democracy.

Prospects Glacial -----

17. (C) The months following the Lunar New Year holiday on January 28 could offer the most favorable environment for cross-Strait economic liberalization in years. Some of the most important priorities, direct air links and opening tourism, are currently the subject of unofficial cross-Strait discussions. The announcement on November 16 of Lunar New Year charter flights in January and February 2006 was a positive step. Reports from officials and industry associations of progress on cross-Strait weekend passenger charters and cargo charters are an indication that the administration is serious about moving forward on these initiatives.

18. (C) The December 3 local elections sent a strong message of support for the KMT, which has successfully portrayed itself as the party that can work with the PRC and will implement cross-Strait economic liberalization measures. Although allegations of corruption in the ruling Democratic Progressive Party (DPP) had more impact on the election results than cross-Strait issues, it is increasingly clear that a majority of Taiwan voters support more open economic relations with the PRC. In addition, the current opening in the political calendar is fairly large with the Taipei and Kaohsiung mayoral elections up next in December 2006 and the legislative and presidential elections scheduled for December 2007 and March 2008 respectively. The administration has some breathing space that could allow the DPP to implement measures that its pro-independence base does not support.

19. (C) Progress might come after the planned second Economic Development Advisory Conference (EDAC). For the second time, President Chen will convene an EDAC of business leaders, scholars, and other experts to make economic recommendations on a comprehensive range of economic issues. Cross-Strait economic issues will be high on the EDAC's agenda. This blue ribbon panel could give Chen the political cover he needs to implement some of these longstanding proposals. The dates for the conference are unclear at this time, but it will probably take place sometime after the Lunar New Year holiday in late January, and could benefit from a likely rise in cross-Strait goodwill that holiday charter flights will generate. If the PRC takes no provocative measures in the interim, this confluence of events could give the DPP administration the opportunity to implement liberalization measures that some in the government have been waiting for.

10. (C) However, there are also signs that the Chen administration will do nothing to speed up the pace of cross-Strait economic liberalization. The administration's original plans call for the EDAC to take place January 19-21, but the day after the ruling DPP's sound defeat in the December 3 local elections an Executive Yuan official indicated that it might be postponed, suggesting that President Chen may ensure that his pre-election prediction that a Pan-Blue victory would "tighten" cross-Strait relations becomes a reality (ref P). Another bad sign is the continuing delay on the applications made by semiconductor manufacturers Powerchip and ProMos to build factories in the PRC. The two firms applied almost a year ago. Taiwan Semiconductor Manufacturing Company's (TSMC) investment in the PRC was approved nearly three years ago on February 26, 2003. Approval for the Powerchip and ProMos projects would not represent any kind of breakthrough in cross-Strait economic policy, and yet the applications continue to languish in the approval process.

11. (C) The Chen administration has already had several chances to live up to the "active opening" portion of its "active opening, effective management" cross-Strait economic policy. To date, changes have come rarely and often only after the political opposition has forced the administration's hand. There may be some important steps forward next year. Most importantly, there may finally be some sort of regular direct aviation links. However, there is little reason to suspect that this government will

change the glacial pace of cross-Strait liberalization or its attitude about economic relations with the PRC.

Recommendation - Continued Pressure

12. (C) U.S. advice to both sides of the Strait to take pragmatic action has helped keep these important economic liberalization proposals on the Chen administration's agenda, despite tendencies to govern from the DPP's pro-independence base. Continued efforts will be essential if the current administration is to make further progress toward implementation. U.S. officials at all levels should continue to urge Taiwan to execute policies that will further enhance the strong economic ties between the PRC and Taiwan.

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